Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:ILD:TL-N-4378-98
G:\CASES\[redacted].LC\SOFTWARE\final.fs adv.wpd
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date: April 29, 1999

to: District Director, Illinois District
Attn: John Leaver
Case Manager E:1809

from: District Counsel, Illinois CC:MSR:ILD

subject: Internal Software R & E Credits

[redacted]
EIN: [redacted]
Years: [redacted]
POA: <none>

By memorandum dated April 7, 1999, we provided you with advice on this matter, and noted that the advice was subject to post-review in our National Office. Today we received two recommendations concerning our memorandum from Field Service. First, they recommend that we make explicit that the payments under Part Two of the [redacted] project should be capitalized, a point which was merely implicit in our memorandum. Second, they recommend that we expand our discussion of the law.

We agree with Field Service, and have incorporated their recommended language into this memorandum. The changes have bolded for ease of reference. The changes do not alter our previous advice.

Issue and Conclusions:[1]

[redacted] ("[redacted]") made payments to outside consultants (1) [redacted], ("[redacted]") and (2) [redacted] ("[redacted]"), along with several other smaller consultants, under separate contracts in connection with the development of two internal software systems. [redacted] ([redacted]) and [redacted] ([redacted]) **You have asked us whether payments to outside consultants, payments to employees of the taxpayer, and costs of supplies may be treated as research and experimental expenditures under section 174 or costs of developing computer software under Rev. Proc. 69-21, and deducted currently, or whether the amounts in issue are costs of purchased software which must be capitalized.**

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[1] You had also asked about the § 41 research credit. We understand that the taxpayer now concedes that the credit is not allowable.

The payments under Part Two of the [redacted] project should be capitalized by the taxpayer as purchases of computer software. The other expenses may be currently expensed as a cost of developing computer software.

FACTS :

[redacted] is the [redacted] direct marketer of [redacted] in the United States. In [redacted], [redacted] decided that it needed new computer software applications designed to meet the future needs of the business. Two systems, [redacted] and [redacted], were approved as projects.. [redacted] hired consultants, [redacted], for the [redacted] project and [redacted] ([redacted]) for the [redacted] project.

In both instances, the taxpayer contracted with third party vendors, [redacted] for [redacted], and [redacted] and [redacted] for [redacted], for the purchase of hardware and software to be used for the systems. The taxpayer also contracted with the vendors and other third parties for services in adapting the systems to fit its requirements, and train its employees in its use.

Via Schedule M, [redacted] wrote off $[redacted] and $[redacted] for [redacted] and [redacted], respectively, which represented book expenditures for the projects. As we understand matters, all costs associated with the purchase and implementation of [redacted] and [redacted] were capitalized and amortized for book purposes. However, for tax purposes, the taxpayer expensed "development costs" under § 174. Development costs were identified as "outside consulting fees and internal information services' programming," referred to as "the fees" for purposes of this memorandum.

[redacted]

[redacted] was intended to replace the taxpayer's existing system of recording orders from customers. According to the [redacted] Project contract, Stage One of the project was the preparation of the functional specifications and architectural bench marking. State Two was the design and implementation of the system (Stage One Contract, p. 1.) The work done on Stage One of the project ([redacted]) was on a time & materials basis. The cost of [redacted]'s staff hours to be expended on Stage One was estimated to be $[redacted], to be billed monthly (Stage One Contract, p. 11) and [redacted] was to pay for any materials, including specialized hardware, needed. (Stage One Contract, p. 12)

A fixed price contract was drawn up for Stage Two (Stage One Contract, page 1.) The total cost, per [redacted]'s corporate purchase order, for Stage Two was to be $[redacted], with equal monthly payments over ten months. [redacted] was to implement "the agreed list of functions," run the tests to show that they worked, train [redacted] staff, run the system in parallel with the existing system for at least a month and then cut over to the new system, and provide subsequent support for ninety days. ([redacted] Stage Two Contract, p.1.) Costs of correction under the warranty provided by [redacted] were borne by [redacted]. ([redacted] Stage Two Contract, p. 6.)

The "primary deliverable" under the contract was "an operational system." (Stage Two Contract, p. 7) Stage Two was extended and expanded on , at a fixed price of $.

was intended to assist the taxpayer in identifying potential customers and constructing a marketing plan for specific customers. The taxpayer sought proposals for the acquisition and customization of software for . after selecting for the project, the taxpayer entered into a "Special Cost Agreement" under which the customization Project was divided into four phases: Phase One (Front-end application & Customer Subset Dimension); Phase Two (Environmental Performance Tuning; (Phase Three (Customer Subset Dimension with Attached Attributes); and Phase Four (Customer Subset Dimensions with Calculated Attached Attributes.) The parties agreed to fee schedules based on anticipated hours worked by to carry out all the phases.

DISCUSSION:

Section 174(a) provides, in part, that a taxpayer may treat research or experimental expenditures that are paid or incurred by the taxpayer during the taxable year in connection with the taxpayer's trade or business as expenses that are not chargeable to the taxpayer's capital account. Treas. Reg. § 1.174-2(a)(1) defines the term research or experimental expenditures. Generally, the definition in Treas. Reg. § 1.174-2(a)(1) provides that research or experimental expenditures are those "which represent research and development costs in the experimental or laboratory sense."

Treas. Reg. § 1.174-2(a)(2) states that the provisions of section 174 apply not only to costs and expenditures for activities undertaken directly by the taxpayer but also include expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization. However, Treas. Reg. § 1.174-2(a)(1) states that the term research and experimental expenditures does not include the cost of acquiring another's patent, model, process, etc.

Rev. Proc. 69-21, 69-2 C.B. 303, provides guidelines to be used in connection with the examination of federal income tax returns involving costs incurred to develop or purchase computer software. Section 2 of Rev. Proc. 69-21 describes computer software as all programs or routines used to cause a computer to perform a desired task or set of tasks and the documentation required to describe and maintain these programs.

Section 3 of Rev. Proc. 69-21 states that the cost of developing software closely resembles research and experimental expenditures that fall within the purview of section 174 and therefore accounting treatment similar to that used for costs incurred under section 174 is warranted. This section further states that the Internal Revenue Service will not disturb a taxpayer's treatment of costs properly attributable to the development of software when all of

the costs are treated as current expenses and deducted in full in accordance with rules similar to those applicable under section 174(a).

Section 4 of Rev. Proc. 69-21 states that the Service will not disturb the taxpayer's treatment of the costs of purchased software if certain practices are consistently followed. Paragraph 2 states that when such costs are stated separately from the cost of the hardware (computer) they may be recovered by amortization deductions over a period of five years or a shorter period when a useful life of less than 5 years can be established by the taxpayer.

If computer software is custom made for the taxpayer, and the developing party is responsible for its operability, then the transaction would be substantially the same as that of a 'purchase' and thus outside the purview of section 174(a) and section 3 of Rev. Proc. 69-21. Thus, the agreements between the taxpayer and the consultants must be examined in their entirety to determine which party bears the risk of the software's functional utility.

The taxpayer maintains that it bore the risks associated with the "development costs" portions of the two projects. It appears to us that the facts show that the taxpayer does bear the risk of loss with respect to these costs, except for the costs associated with Part Two of the [redacted] project.[2]

The [redacted] project was documented by a "Special Cost Agreement" between [redacted] and [redacted]. Under this agreement, [redacted] was compensated based on a projection of hours and an hourly compensation rate, with the taxpayer being charged only for actual hours if the project came in under the projected time. [redacted] had the right to unilateral terminate the contract, but was required to pay [redacted] for outstanding invoices if it did so. Various other contractors were hired for specific tasks, and it appears that [redacted] was responsible for paying them. Therefore, it appears to us that [redacted] bore the risk of loss on the project.

Part One of the [redacted] project covered how [redacted] would participate with [redacted] in defining what the [redacted] system would do, and proposing what kind of hardware and software would be necessary to accomplish the objective. An hourly rate was agreed upon for the time of the [redacted] personnel, and [redacted] was to be billed based on invoices detailing the services rendered by each individual. [redacted] was also responsible for other expenditure made by [redacted], subject to advance approval by [redacted]. From this, we conclude that [redacted] was free to suspend or terminate the project at any point, or continue it as long as it wanted, but that in either event, [redacted] was responsible for whatever Part One of the project cost.

Part Two of the [redacted] project contemplates that [redacted] would deliver an operational system based on the "Functional Specification" created as a result of Part One of the project. [redacted] had the right to reject the delivery based on the outcome of an agreed Acceptance Test Plan. That is, if the system failed to pass the test, [redacted] would not have fulfilled the contract. Specific components of the

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[2] And assuming that the costs do not include such things as training the taxpayer's employees on how to use the systems.

operational system are detailed in section 4 of the Part Two contract, and the payment terms laid out in section 8 references invoices to be submitted by [redacted] for each deliverable item. The terms included a specific price to be paid by [redacted] to [redacted], with a specified payment schedule linked to the deliverables. If [redacted] failed to deliver, it would not be paid. Clearly, [redacted] did not bear the risk of the project failing to produce the system it wanted.

Richard A. Witkowski
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